Mario Draghi: The social market economy and the solutions to the global financial and economic crisis

Remarks by Mr Mario Draghi, Governor of the Bank of Italy and Chairman of the Financial Stability Board, for the European People's Party high-level policy debate on "The social market economy and the solutions to the global financial and economic crisis", EPP Statutory Congress, Bonn, 9 December 2009.

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I am very pleased to be here to talk about progress in finding and implementing solutions to the global financial crisis. You have decided to focus today and tomorrow on issues that are critically important to our economies and our citizens. And I am honoured to have this opportunity to speak about where we are in terms of financial regulatory reform, what has been achieved to date and the priorities ahead.

One year after the climax of the financial crisis, market conditions have eased significantly and a degree of confidence in the financial system has returned. However, the market reaction to Dubai's woes is a reminder that they remain unusually vulnerable to shocks.

The crisis has implied a massive transfer of debt from the private to the public sector. Fiscal positions have deteriorated across the board at an unprecedented pace. Public deficits in the G7 countries have surged from 2% of GDP in 2007 to 10% today. The limits set by the Stability and Growth Pact will be exceeded until 2014 at least for the euro area. Although necessary and unavoidable, those extraordinary borrowing needs, combined with long-term fiscal challenges on healthcare, pension systems and climate change, will lead to public debt in excess of 100% of GDP in OECD countries in 2010 (up from 74% in 2007).

It is no surprise therefore that markets have been recently more sensitive to accumulating debt burdens in government and quasi-government sectors. Sovereigns represent an increasing share of transactions in credit protection markets (CDS), as market participants challenge the assumption that they are risk-free. Government auctions have faced from time to time unsatisfactory demand, even for highly-rated issuers. Sovereign CDS premia remain volatile and elevated. Markets also show more discrimination across countries. While developed countries come under funding pressure, emerging countries with low debt levels are now able to issue long term, as shown by the recent 50-year bond of China, sometimes at fixed rate and in local currency, which was unimaginable just a few years ago. So there is a way out, but governments need to communicate credibly their medium-term plans to restore fiscal sustainability, in order to limit upward pressure on their funding costs and to retain their ready access to global markets. That is important not only to deliver fiscal prudence, but also to avoid adverse spill-over to the rest of the financial system given their pivotal benchmark status.

On the funding front, there are also heightened risks of crowding out. Global refinancing needs are firmly skewed towards shorter term maturities. Estimates differ, but bank and corporate bond redemptions hover around USD 3 to 4,000 billon annually from 2010 to 2012, double the annual amount of the mid-2000s. Roll-over of government debt will come on top of those needs. Leveraged borrowers such as high-yield companies also face refinancing pressure. And securitization markets are thawing only very slowly.

Overall, markets will need to refinance higher debt levels with lower average quality and with a reduced tolerance towards leverage, in a time window when support schemes will progressively unwind. Such absorption pressure may well lead to higher and more volatile funding costs. Therefore, it is now time that financial institutions and corporates engage proactively in lengthening their debt profile and tapping global markets in an orderly fashion given the risk that they may otherwise be forced to raise funds under less attractive terms.

Amidst these challenges, restoring a well functioning market-based economy also requires exiting from the exceptional financial sector support measures introduced since 2007. Clearly, the timing, speed and modalities of exit involve important trade-offs, and judgment will need to be used. Implementing exit strategies will require striking an uneasy balance between exiting too early and too late. This underscores how important it is that we resolve the regulatory issues in front of us, which will be part and parcel of our ability to exit this crisis with confidence in the resilience of our financial system.

Bolstering the resilience of the financial system is a broad project encompassing a considerable number of related measures. It involves multiple layers of policy authorities across countries and sectors. And it requires coordination and a joined-up international response, both for making our policies effective and for establishing a level playing field. Driving forward a coordinated global regulatory response has been the key role of the G20 Leaders and of the Financial Stability Board, which I have the honour to chair.

Much policy development has been achieved – more than meets the eye – that when implemented, will result in a very different financial system than the one that brought us this crisis: a more resilient, disciplined, less procyclical and less leveraged system; one where the perverse incentives to excessive risk taking – with private gains and socialised losses – that characterised the recent past will have been removed. Substantial progress has been made on a very broad front, and we have now not only a consensus internationally on the objectives of the reform agenda, but a broad commitment to consistent implementation at the national levels.

To name just a few of the significant changes that have already occurred: we have closed loopholes and corrected shortcomings in the bank capital and liquidity frameworks; we have addressed weaknesses in accounting standards; improved risk management and disclosure standards for financial institutions; introduced new standards and principles on sound compensation; and we have enhanced oversight of credit rating agencies and hedge funds.

But we are far from done. Work is underway in critical areas, and implementation of the full set of needed reforms will require political will and perseverance. We simply must take the steps that are needed to ensure we can exit this crisis confident that we have put in place a much stronger system for the future.

A lot of what needs to be done requires international consistency because finance is global. It is therefore of critical importance that, as we set out a constructive path for reform in our respective constituencies, we work to ensure that this takes place with a view to preserving the advantages of integrated global financial markets and a level playing field across countries and sectors. The Financial Stability Board takes this very seriously.

Completing and implementing financial reform thus remains a key imperative – both nationally and internationally. Let me now speak to some of the areas where critical decisions in the months ahead will determine whether credible reform is achieved. I will leave aside the issues of reform of national and regional oversight structures, and focus on bank capital and liquidity, compensation, accounting, derivatives, and addressing the moral hazard posed by institutions that are too big to fail.

- Improving bank ***capital*** is clearly the single most important project to build greater resilience into the system. Through the Basel Committee on Banking Supervision, we have now agreed the key measures needed to strengthen the capital framework – raising the quality and quantity of capital; introducing a leverage ratio that will constrain bank leverage; and requiring banks to create countercyclical buffers that can be drawn down during bad times. Proposals on the first two will be developed by the end of this year and on the last by the middle of next year. A comprehensive impact study and the calibration of the overall capital level will be undertaken by end-2010, looking at the cumulative effect of all the reforms and how they interact. In other words, there will be no simplistic layering of the different elements. The

changes to Basel II will be substantial, and they will be phased in over an extended period so as avoid any adverse interaction with current conditions.

- Regulation is being substantially enhanced on bank liquidity as well. The Basel Committee will issue for comment early next year a new minimum liquidity standard directed at ensuring global banks hold sufficient high-quality liquid assets to withstand a stressed funding scenario specified by supervisors. This too will be subject to an impact assessment.
- On ***compensation***, countries are taking actions to implement the FSB standards issued in Pittsburgh and others will be following shortly. These standards address the structure and governance of compensation; they also call on firms – on public policy and prudential grounds – to restrict compensation levels so long as this is needed to retain and build the necessary level of capital. This is an area in which it is absolutely essential that authorities take robust collective steps if they are to dispel expectations that business can go on as usual. The FSB is now launching a review of the actions taken by authorities and firms, focusing on consistency and effectiveness at achieving the intended results, and will propose additional measures as needed.
- On ***accounting***, we have seen progress in the revamping of financial instruments accounting. But we are quite some distance from achieving the objectives of improved, converged standards that are less complex and less prone to amplifying economic cycles. This is a difficult area that we are pursuing vigorously through dialogue between the accounting standards setters, prudential regulators and other stakeholders. But we must do so in way that respects the integrity and independence of the standards setting process.
- Last but not least, we must reduce the ***moral hazard*** posed by institutions that are too large, or too complex, or too interconnected to fail. The large-scale support we provided in this crisis to stave off systemic collapse has materially worsened moral hazard risks. Why should our financial firms now believe that authorities will not stand behind them if conditions were to turn again to the worse? Moreover, many of our banks have become larger, not smaller as a result of crisis-related mergers. Moral hazard risks pose a large prospective burden for taxpayers and are a serious threat to the maintenance of a market-based system. So what is to be done?
- At the Pittsburgh Summit, the G20 Leaders called on the FSB to propose by end-October 2010 possible measures to reduce these problems. We are now evaluating approaches under three headings, while recognising that there will be no silver bullet or a one-size-fits all solution in this area:
  - First, ***reducing the probability and impact of failure*** of a systemically important institution. The aim is to link capital and liquidity charges more closely to the externality or spill-over costs of failure. Here, we will be investigating a capital surcharge for systemic importance, as well as what role new capital instruments, such as contingent capital, or other insurance schemes could play. We will also consider options to incentivise structures and business models that support effective supervision.
  - Second, ***improving resolution capacity***, by establishing credible resolution frameworks for large interconnected financial institutions – frameworks that have the ability and funding to preserve the continuity of a failing institution's core functions, and the authority to impose losses on shareholders and unsecured creditors Work is also underway to improve ex ante crisis preparedness and resolution, including through the use of "living wills". We must recognise, at the same time, that achieving effective resolution of cross-border entities will ultimately require addressing very difficult issues – such as

recognition and harmonisation of resolution regimes, and how to share across borders the costs of a resolution.

– Third, ***strengthening the core financial infrastructures*** and markets to reduce contagion risks, including by moving over-the-counter derivatives onto exchanges or central clearing platforms. Action in this latter area can shrink the risk exposures arising from interconnectedness that contribute to authorities having no choice but to bail out systemically important financial institutions.

Let me conclude with two general remarks.

First, effective work to strengthen the global financial system requires policies that are well designed and will be robust over the long run. This necessarily takes time. It is important, therefore, that governments send a strong message that they are determined to see these reforms through. Where international policy development is ongoing, it needs continued support; where such policy work has concluded, we need commitment to consistent national implementation.

Second, given the commitment G20 Leaders have made to coherent approaches as we improve financial regulation, we must strive to overcome inconsistencies in final rule-making and implementation at the national and regional level so as to achieve a level playing field. The FSB will monitor this by undertaking regular peer reviews among FSB members – both country-by-country, and by topic across the entire membership. The fundamental value of our peer reviews will be the dialogue and constructive engagement of our members towards the common objective of a well regulated, open, and market-based financial system.

In a global context, it is of course critically important that standards are raised everywhere. In the FSB, we have embarked on a process to identify the non-co-operative jurisdictions that fail to implement internationally agreed standards in the prudential and regulatory area. We are developing a toolbox of measures that will incentivise adherence to reforms in these jurisdictions.

We are working closely with the IMF in these areas, which has a key role in surveillance of the global financial system, and, together with the World Bank, are well-established assessors of authorities' implementation of key financial sector policies and standards. We will also collaborate closely with the new European Systemic Risk Board and the European financial supervisory structures that have now been put in place. Our shared goal is a stronger and more resilient international financial system in which threats to stability are engaged earlier, are better cushioned when they materialise, and where protections are adequate to give our citizens and countries confidence in an open and integrated financial system.